



“The Perverse Effect of Credit Default Swaps: A Catastrophe in the Making”

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Credit Default Swaps (CDS) were originally designed for owners of debt instruments (corporate bonds, asset-backed securities, mortgage-backed securities and loans) to purchase insurance against the possibility of default.

By purchasing default insurance the catastrophic risk was transferred from the owner to the risk underwriter. Of course, the underwriter received a fee for providing this service. The amount of the fee is dependent on the perceived risk of the credit being underwritten, and the length of the policy. This practice of default risk underwriting debt still exists, and serves the purpose of allowing risk to be transferred from one party to the next.

However, in recent years the use of Credit Default Swaps has expanded well beyond the notion of risk transfer. The CDS industry has grown in size from \$3.8 trillion in 2003 to \$62 trillion at the end of 2007, far in excess of the estimated \$5-plus trillion in actual debt outstanding.

What happened? The CDS market is unregulated. It allows any “player” -- underwriter (seller) or buyer -- to participate in this market. Anyone can participate in a swap, betting on the likelihood of a debt instrument defaulting, or credit spreads widening or narrowing, without the necessity of owning the underlying instrument (“reference debt”). To place these bets, no cash, or little cash, is required. Sellers (underwriters) can issue insurance without any reserves against the possibility their bet may go bad.

Of course, the buyer relies on the seller to pay off in the event of loss. This risk is defined as counter-party risk. With \$60-plus trillion in swaps outstanding, it is fair to assume that a large number of sellers (underwriters) are not financially able to make the necessary payment when required.

This condition is most readily observed in the Hedge Fund market where it is estimated that Hedge Funds are sellers (underwriters) of CDS, insuring exposure of over \$14.0 trillion. Recent estimates put the net asset value of all Hedge Funds under management at just over \$2 trillion. Fourteen trillion dollars’ worth of exposure will not all melt down simultaneously, but the \$2-plus trillion in assets is completely inadequate to cover the risk exposure.

How real is the problem? AIG, a major underwriter (seller) of CDS, has booked a cumulative charge of \$19.3 billion on the firm’s Credit Swap portfolio. This contributed to a 22% decline in AIG’s book value with potentially more write-off to come.

In effect, the CDS market has morphed into a highly speculative, unregulated arena where fortunes are made and can be quickly lost -- quite the opposite of its original intent, which was to create a vehicle for mitigating risk. This perversion has substantially increased the risk for the vast majority of major financial players to the point of potential catastrophe.

The following represents a list of major players involved in this speculative frenzy. Large Commercial banks dominate the CDS market, followed by Hedge Funds. However, Investment Banks and Insurance Companies have substantial exposure. I would not be surprised to see some serious meltdowns of equity values, even in the face of recent price declines, followed by a rash of litigation.

James A. Kaplan
CHAIRMAN

***(List of Major Credit Default Swaps Players
on next page)***



Major Credit Default Swaps Players

Commercial Banks

Company Name	Ticker Symbol	AGR® Rating
Bank of America Corp.	BAC	Very Aggressive
Citigroup Inc.	C	Very Aggressive
JP Morgan Chase & Company	JPM	Very Aggressive
Wachovia Corporation	WB	Aggressive

Investment Banks

Company Name	Ticker Symbol	AGR® Rating
Lehman Bros. Holdings, Inc.	LEH	Very Aggressive
Goldman Sachs Group, Inc.	GS	Aggressive
Merrill Lynch & Co., Inc.	MER	Very Aggressive
Morgan Stanley	MS	Very Aggressive

Monoline Insurance

Company Name	Ticker Symbol	AGR® Rating
ACA Capital Holdings	ACAH	N/A*
Ambac Financial Group, Inc.	ABK	Very Aggressive
MBIA, Inc.	MBI	Very Aggressive
Radian Group	RDN	Very Aggressive
Security Capital Assurance Ltd.	SCA	Very Aggressive

Reinsurance Companies

Company Name	Ticker Symbol	AGR® Rating
Aegon	AEG	N/A*
American International Group, inc.	AIG	Very Aggressive
AXA	AXA	N/A*
Fairfax Financial Holdings Limited	FFH	Conservative
Hartford Financial Services	HIG	Very Aggressive
XL Capital, Ltd.	XL	Average

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